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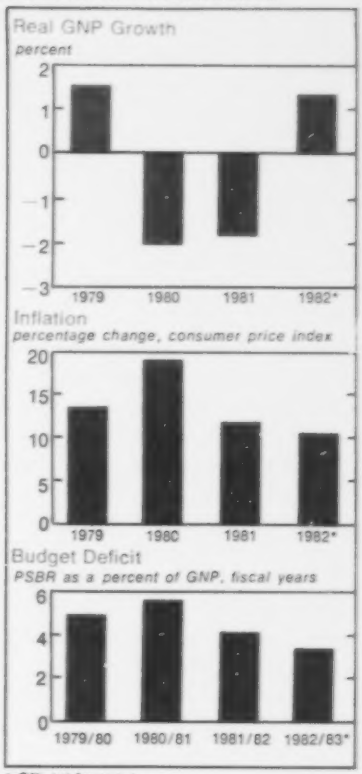
British Economic Policy Back on Course

Britain's budget for the upcoming fiscal year reaffirms the Thatcher government's commitment to the long-term strategy announced soon after coming to office in 1979. The unexpected depth of the U.K. recession had forced considerable deviation from the government's stated policy intentions. Based on this, some observers were predicting that the prospect of an election by 1984 would force the government to abandon its strategy completely this year and go for more traditional vote-catching policies. This has not happened. Instead, now that the recession seems to have come to an end, the government is returning to the original course set forth in 1979—albeit from a new starting point.

The new budget provides for some modest tax relief: Employers contributions to national insurance have been cut by 1%, and individual income tax allowances have been boosted by 14%—even more than the 12% increase equivalent to last year's inflation rate that the law requires. Part of the lost revenue will be made up from increased taxes on autos, cigarettes, and alcohol, but the overall tax take has been reduced from pre-budget levels. In addition, government expenditures are set to fall over the year and this will help bring down the deficit, or Public Sector Borrowing Requirement (PSBR), to £9.5 billion, or about 3.5% of GDP—significantly below the £10.5 billion PSBR for the fiscal year just ending and the £13.2 billion for fiscal 1980/81. The government has also restated its intention to hold the growth of the money stock within an 8%-12% band in the coming year. In addition, however, the policymakers have increased their maneuvering room by applying this target to three different measures of the money supply instead of just to sterling M3. The presumption—as yet to be put to the test—is that any overshooting by only one of the three would be ignored.

The government now expects some 1.4% growth in real GDP in 1982 and predicts the inflation rate will fall to 9% by year end. The implied 10.4% rise in nominal GDP for the year gives some hope that the money supply can be held within its target. Moreover, signs look promising that British interest rates will continue their recent downtrend. A major uncertainty for the interest rate outlook, however, is the world price for oil and its influence on the pound's exchange rate. The government has made it clear that it does not want to see any major sterling decline. And should the pound come under pressure, domestic interest rates would almost certainly be raised to defend it.

Selected U.K. economic indicators



* Official forecast

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French reflation policy may come under pressure as inflation and payments problems emerge.

The French economy slacked off considerably in the fourth quarter. Provisional figures indicate real GDP growth slowed to an annual rate of only 0.4%, bringing real growth for 1981 as a whole to 0.7%, despite robust consumer spending and strong export performance over the first half of the year. The current stance on fiscal and monetary policy remains reflationary, suggesting the economy may rebound in 1982 back toward the official target of 3% real GDP growth. However, there are signs emerging that the longer-term outlook may be somewhat less healthy. Government attempts to secure voluntary wage restraint have so far met with little success. And this may eventually undermine the aims of current policy as reflation leads to inflation and balance-of-payments difficulties. The trade deficit has already doubled in the past six months and the current-account gap in 1982 may expand to almost twice the 40 billion French franc deficit recorded in 1981. The current pace of monetary growth suggests that inflation—still at 13%—could become even more troublesome. Increasing evidence of these problems is likely to place selling pressure on the franc and may force some partial retrenchment in policy later on.

Austrian economy continues sluggish; recovery tied to export strength.

Similar to most of its European neighbors, Austria's domestic economy has remained lackluster. The latest data show that real GDP remained flat in the third quarter, as a 1.8% decline in domestic demand was offset by a 6.3% rise in export volume. Real GDP for 1981 as a whole is expected to have remained unchanged. And consumer prices showed an average rise of 6.8%—still high by historical standards. As a result of the economy's poor performance, seasonally adjusted unemployment rose to an all-time high of almost 120,000 in December, some 4% of the workforce. The net budget deficit in 1981 amounted to some 27.5 billion schillings, about 2.6% of GDP. The 1982 budget deficit is now expected to rise to 31.6 billion schillings, some 2.8% of GDP. Hopes of a 2% rise in real growth in 1982 are pinned on continued strong growth in exports, which will be made possible by a substantial rise in Austria's export competitiveness but will nonetheless remain dependent on an upturn in the economies of its trading partners in the second half of 1982.

Greenland votes to withdraw from EEC.

Negotiations are likely to begin soon on the withdrawal of Greenland from the European Economic Community. As a Danish province, the island had been taken into the Common Market in 1973, when Denmark joined, despite strong local opposition. Now more autonomous, Greenlanders last month, by a relatively narrow margin, voted to end their EEC affiliation. It now seems inevitable that the local parliament will ask the Danish government to arrange the terms of the withdrawal. The move is unlikely to alter Greenland's economic situation to any great extent, at least in the short run, as negotiations will probably last for more than a year. The longer-term impact is less certain. In return for giving EEC fishing boats free access to its waters, Greenland now receives about $22 million annually in EEC aid. If it leaves the Community, however, Greenland will be able to charge the EEC for fishing rights to offset the loss of economic assistance. In the end, the ice-bound province may well fall into the same category as some of the small French colonies that have especially favorable arrangements with the EEC while remaining non-members.

Banking reform could significantly alter Japanese financial structure.

Japan's new banking law scheduled to become effective April 1 could set the stage for substantial changes in the structure of the Japanese financial markets. Among its many reforms, the new law is expected to expand the market for national bonds and limit potential underwriting losses by providing for the direct sale of bonds to the public at bank teller windows beginning April 1, 1983. Currently, the government pressures syndicates of financial institutions to underwrite new issues of national bonds at below-market yields. Banks now risk onerous capital losses, particularly when market rates are rising, if they are forced to sell the bonds in the secondary market. Banks anticipate that under the new law,

however, the bonds could be sold over the counter to individuals at a price closer to their purchase price, since the issuing rates on the bonds would be higher than the rate available on savings deposits. The new law also includes a provision allowing Japanese banks and securities firms to buy and sell domestically commercial paper and certificates of deposit issued abroad. However, capital outflow is likely to result as investors adjust their portfolios to take advantage of the new opportunities. And in anticipation of this effect, Japanese authorities just last week announced the postponement of the permission to sell foreign CDs and commercial paper—presumably at least until the yen strengthens.

Hong Kong's new "supply-side" policies include focus on international finance.

The Hong Kong government's announced budget for fiscal 1982-83, which begins April 1, includes a number of "supply-side"-oriented policies such as reduced growth of government spending and tax cuts for individuals and businesses. Of particular interest, however, are tax measures specifically directed toward boosting Hong Kong's position as an international financial center. Foreign-currency deposits were exempted from tax on interest, and for Hong Kong dollar deposits, the tax was cut to 10% from 15%. The authorities are hoping these changes will help attract foreign exchange trading business from abroad without causing a shift from local to foreign currencies in the domestic money market. The government is still projecting a budget surplus for the upcoming fiscal year, and thus far, this projection appears quite credible. In the past, government economic forecasts have erred mostly on the side of conservatism. Real growth for calendar 1981 is now estimated to have been over 10%—more robust than last year's official projection of 8% and quite a remarkable performance in view of the world recession and rising protectionism.

Mexico offers business support program following peso devaluation.

The Mexican Government has initiated a number of measures to help the economy and business firms adjust to last month's peso float and devaluation. In order to reduce demand and inflation pressures, the authorities have cut public expenditures 3% and lowered import tariffs on 1,500 goods. In the way of more direct assistance for business, the government will allow firms federal income-tax deductions for up to 42% of any foreign exchange losses from the February devaluation, as well as deferral of income tax payments for up to one year, on a case-by-case basis. In addition, companies that import equipment can take advantage of a special swap program that absorbs exchange rate risk. The adjustment program also includes other measures directed toward helping firms meet increased liquidity needs resulting from higher costs associated with the devaluation. In general, the government hopes this program will encourage continued business investment through this difficult period for the Mexican economy. If the government itself supports these intentions with fiscal caution and control of public sector credit, the proper environment will be created for business investment decision-making.

Modest improvement in Kenyan economy expected, despite continued imbalances.

Despite marginal improvement in its performance in 1981, the Kenyan economy continues to experience substantial imbalances. Real GDP is reported to have registered 3%-4% growth in 1981, up from 2.4% the year before, and the current account of the balance of payments appears to have narrowed its deficit by some 15%, to an estimated $835 million. However, a growing budgetary gap has necessitated increased resort to inflationary central bank finance. Moreover, external sector reserves have fallen to a 5-year low, while liabilities have risen sharply. The mild deceleration of price increases earlier in the year was undoubtedly reversed toward year-end, following a 15% devaluation of the shilling in September. This year, favorable rains suggest some improvement in economic growth—possibly to 5%. But no narrowing of the budgetary deficit nor any decrease in the rate of inflation is expected. While some further decline in the current-account deficit is likely, the low level of external reserves will require shifting the financing of the shortfall entirely to foreign sources.

A Lasting Deceleration in Inflation?

Inflation is slowing more quickly than seemed likely just last summer, when prices were rising at double-digit rates. The producer price index actually fell 0.1% in March, bringing the year-over-year increase to 5.4%, down sharply from the 12.9% peak in 1980. The slowdown in consumer prices has not yet been quite so dramatic, but February's 0.2% increase still brought the year-over-year increase down to 7.7% from 13% in 1979.

As welcome as this deceleration in inflation is, however, the rate is still high by historical standards. Moreover, economists do not agree on whether this decline will continue beyond this year. Some argue that the decline is only temporary, a result of the recession in 1980 and the current downturn that began in mid-1981. In this view, the recovery expected later this year and in 1983 would likely bring a reacceleration of price rises. Other economists, however, contend that the current slowdown in inflation is a result of the Federal Reserve's more stringent monetary policy that started in 1979. And as long as money growth continues to moderate, so will inflation.

Those who argue that the decline in inflation is the result of cyclical forces—and thus temporary—generally use a "bottom-up" approach to analyzing inflation. That is, they look at the trends in the costs of various factors of production—labor, raw materials, and capital—for clues as to what will happen to final output prices. For example:

- Labor costs are rising less rapidly as the demand for labor falls. Wage rates rose at a 9%-10% clip throughout 1980 and early 1981, despite an increase in unemployment, apparently in response to past inflation. But the demand for labor remained weak as the recovery proved to be short-lived. This, combined with a slowing of price inflation, has helped to temper labor's demands for higher wages. By late 1981, the increase in the average wage rate had fallen to 7%. Contract renegotiations in the auto industry and elsewhere should work to slow wage gains even further.
- Raw materials prices have fallen in four of the last six months, bringing the year-over-year increases down to about 8½% from 19% during 1980. Raw materials producers were initially hesitant to cut their own production and prices immediately in the face of weak demand, hoping to maintain their revenue. However, as inventories have piled up, excess supply has exerted downward pressure on both prices and output.
- Profit margins after taxes have shrunk by about 20% over the last two years, reducing the average return on capital. With lower sales volume and operating rates, most industries are having a hard time passing along even more modest cost increases.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	us cre lions
Austria	Export-led recovery in latter 1982 expected to produce 2% real growth this year.	Nov.	−2%	76.5	+3.1%	Jan.	5,031	+ 2%	2.9	
Belgium	New government loosens wage indexation, tightens fiscal policy; little growth expected in 1982.	Nov.	−1%	118.7	+2.0%	Jan.	4,433	−43%	0.9	
Britain	Official forecast points to stepped-up growth in 1982, but recent statistics remain stubbornly flat.	Jan.	0	524.6	−1.4%	Jan.	14,913	−29%	1.7	
Denmark	Central bank has warned recovery could be weakened by huge budget deficit, now 10% of GDP.	Nov.	+3%	64.7	−0.2%	Jan.	2,306	−29%	1.6	
Finland	Economic growth continues but its pace is slowing.	Nov.	0	51.0	+ 6.0%	Jan.	1,275	−22%	1.1	
France	Business surveys continue to note optimism over near-term output prospects.	Jan.	+2%	657.0	+1.6%	Dec.	22,262	−19%	2.3	
Germany	Domestic activity remaining weak; leading indicators fail to show imminent upturn; unemployment rising.	Jan.	0	822.2	+1.8%	Jan.	41,612	−14%	3.1	
Ireland	Restrictive policies will prevent any economic growth this year.	Oct.	+2%	17.6	+1.9%	Jan.	2,513	− 6%	2.9	
Italy	Real GDP down an estimated 1% in 1981; sluggish recovery expected after mid 1982.	Jan.	−2%	394.9	+4.0%	Jan.	19,286	−13%	2.6	
Netherlands	Economic activity remains depressed; recovery hopes hinge on exports.	Dec.	−3%	159.9	+1.0%	Jan.	8,904	−21%	1.6	
Norway	Oil and gas output down for first time since production began; GDP unlikely to increase this year.	Dec.	+3%	55.4	+3.6%	Jan.	6,024	+13%	4.5	
Portugal	Inflation and tight government budget putting squeeze on real wages and consumer spending.	Oct.	0	23.5	+5.5%	Dec.	544	−32%	0.8	
Spain	Real growth in 1981 was 0.5%; somewhat stronger—but still modest—growth projected for 1982.	Oct.	−3%	195.9*	+1.5%	Dec.	10,805	− 9%	4.1	
Sweden	Economy remains depressed; unemployment figures have reached new record levels.	Nov.	−4%	122.9	+1.4%	Jan.	3,389	−13%	1.4	
Switzerland	Gloomy business prospects for 198[illegible], GDP may decline some 1%.	Sept.	+4%	105.8	+3.9%	Jan.	10,988	−11%	4.4	
Turkey	Economic growth resumes; real GNP in 1981 officially estimated to have expanded over 4%.	n. a.	—	60.2	−0.7%	Dec.	1,285	+ 1%	1.8	1,
Canada	General business conditions at low level of activity with unemployment rising.	Dec.	−4%	274.0**	+3.0%	Feb.	2,695	+10%	0.6	
United States	Indicators point to end of economy's steep slide, but not yet to vigorous recovery.	Feb.	−7%	2,922.2**	+1.9%	Jan.	18,946	+10%	0.8	

*1979 **1981

By the same token, according to those who argue that the current slowdown in inflation is a cyclical phenomenon, as an economic recovery takes hold, the increase in demand for labor and raw materials will put upward pressure on their prices. And at higher levels of output, producers will be in a better position to pass along these cost increases and to rebuild margins, as well. Hence, it is asserted, inflation will speed up.

Although this viewpoint may have some validity in a purely descriptive sense, it has some serious analytical shortcomings. It essentially says that higher prices cause higher inflation—not a very enlightening statement.

An analytically sounder "top-down" approach to inflation forecasting is provided by economists who zero in on forces determining total spending in the economy. Many in this group see money growth as the primary determinant of inflation. Rather than focusing on relative movements of individual prices, which may simply reflect shifts in the supply-demand balance between markets, they look directly at forces that influence the general price level.

Changes in the quantity of money in circulation determine changes in the total value of transactions, or "nominal" demand (assuming that individuals' willingness to hold money remains unchanged), while total "real" demand in the long run is determined by the growth of factor inputs—labor, raw materials, and capital. So money growth in excess of the growth in real activity is likely to result in the bidding up of all prices—that is, in a rise in the general price level, or inflation.

If money growth slows as it has done, on average, for nearly three years, the growth of nominal demand also must slow. Were price-setting behavior to adjust immediately, the level of real economic activity would be unaffected; only inflation would be lower over the time period. However, any price rigidities or delays in renegotiating contracts will have depressing effects on real growth in the short run, because relative price shifts lead to distortions and imbalances in real demand. Once all the price adjustments are made, real economic growth can resume its long-run path based on the growth of factor inputs.

Every post-war recession has been preceded by a period of relative monetary stringency, so it is easy to see how analysts could confuse the patterns of causation of slowing inflation during recessions. More important, however, is the fact that money growth has accelerated during or just after every recession, leading to the all-too-familiar ratcheting upward of inflation.

If the pattern of decelerating inflation is to outlast the current recession, then, a reversion to the earlier pattern of rapid monetary expansion after a recession clearly must be avoided. The question foremost on policymakers' minds is how much of a recovery the economy can eke out, given the Federal Reserve's restraint on nominal demand as it seeks to lower inflation. The faster that price-expectation adjustments occur, the less real output will be lost. Thus, the rapid drop in inflation, and the highly publicized labor concessions, are good news for U.S. economic prospects.

Douglas L. Bendt

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes					exchange rate in U.S. dollars		
of IMF dit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate†	Mar. 24, 1982	current monetary conditions	
0	Current-account deficit was 38.1 billion schillings in '81, vs. 46.8 billion in '80.	Dec.	+ 6%	Nov.	— 3%	6.75%	.0590	Interest rates ease in line with German rates.	Austria
0	Franc devalued by 8.5% against DM in attempt to cut growing trade gap.	Feb.	+ 8%	June	+ 7%	13.00%	.0223	Downward pressure on franc reverses interest-rate fall.	Belgium
287	Current-account surplus likely to remain high after 1981's $16-billion record.	Feb.	+11%	Dec.	+15%	12.83%	1.8035	Sterling weakness prevents substantial interest-rate fall.	Britain
0	Economy still suffering from substantial current-account deficit.	Dec.	+12%	Oct.	+13%	11.00%	.1229	Continued capital outflows point to rising interest rates.	Denmark
60	Jan. saw a fmk. 248 million trade surplus after Dec.'s fmk. 757 million deficit.	Dec.	+10%	Oct.	+12%	9.50%	.2175	Monetary policy remains reasonably restrictive.	Finland
0	Current-account deficit of FF40 billion in 1981 may double this year.	Feb.	+14%	Oct.	+16%	9.50%	.1612	Weaker franc in EMS limits interest-rate cuts.	France
0	Current-account deficit down to 17.7 bn. DM in '81; small surplus likely in '82.	Feb.	+ 6%	Nov.	— 2%	7.50%	.4188	Special Lombard rate reduced to 9.5%.	Germany
0	Trade deficit remains unacceptably large at 144 million pounds in Feb.	Nov.	+23%	Dec.	+ 3%	16.50%	1.4650	High interest rates needed to defend Irish pound.	Ireland
0	Current-account deficit in 1981, estimated at 9 trillion lira.	Feb.	+17%	Sept.	+10%	19.00%	.000765	Banks' interest rates ease slightly.	Italy
0	Trade balance in '81 showed 6.7 bn. guilder surplus, vs. 5.3 bn. deficit in '80.	Feb.	7%	Nov.	+ 1%	8.00%	.3805	Interest rates reduced as guilder remains near top of EMS.	Netherlands
0	Trade balance remains in surplus despite fall in oil export value.	Jan.	+12%	Sept.	+14%	9.00%	.1548	Rules restricting foreign purchases of stocks relaxed.	Norway
41	Soft oil prices should help reduce current-account deficit in 1982.	Nov.	+25%	Sept.	+19%	18.00%	.0150	Monetary growth remains high.	Portugal
163	Peseta has exhibited weakness in Feb. and March.	Dec.	+14%	Nov.	+11%	8.00%	.00950	Money supply (M3) growth was 1% under target in 1981.	Spain
0	Trade account swung into Kr. 600 million surplus in Feb.	Dec.	+ 9%	n. a.	—	11.00%	.1702	Central bank discount rate cut to 10% in mid March.	Sweden
0	Loss of export competitiveness may curtail further current-account strength.	Feb.	+ 5%	Nov.	— 6%	6.00%	.5268	Interest rates fall as central bank boosts liquidity.	Switzerland
293	Current-account deficit shrank to $2.1 billion in '81 from over $3 billion in '80.	Dec.	+30%	Dec.	+23%	30.25%	n. a.	Money remains tight.	Turkey
0	Imports down as economy slows.	Feb.	+12%	Feb.	— 4%	15.04%	.8168	Interest rates at high levels.	Canada
0	Outlook for current account improved with oil price break.	Jan.	+ 8%	Feb.	+ 7%	12.00%	—	Money growth declines, but remains above yearly target.	United States

†most recently reported

World Interest Rates

market rates of March 24, 1982; bond yields as of March 19, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.04	12.83 intervention rate	13.00	9.50	7.50	19.00 penalty rate 22.00	6.00	6.00	5.50
Day-to-Day Money	14.00 March 25	15.04	13.75	9.25	17.00	9.55	20.375	5.00	5.50	6.6875
Treasury Bills 91-day, Middle Rates	12.67 discount basis	14.90	12.5625	14.25	n. a.	n. a.	18.30 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.50 finance paper discount basis	15.65 finance paper 15% tax w/h	12.185	12.90 Certified	16.875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.60	15.60 15% tax w/h	12.5625	12.90 Certified	not traded	9.40	21.9	no market	5.875	no market
Government Bonds Long-term, new and old issues, average yield	13.66	15.50	13.33	10.715 20% tax w/h	16.15	9.32	20.18	10.26	5.30	7.20
Industrial Bonds prime, long-term, new and old issues, average yield	14.90 As Industrials	17.00	14.66	15.68	16.91	9.24	20.45	11.02	6.36	6.91
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	16.50	14.50	17.00	15.95	13.00	21.75 ½ qtrly fee on outstdng.	11.00	9.50	6.00
Bank Time Deposits 3-month	13.95 Cert. of Dep.	16.20	13.437	14.25	17.00	9.35	10.75	8.25 large deposits	5.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.8125	no market	13.5625	no market	27.00	9.125	no market	7.9375	5.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8172	1.8030	.0222	.161	.4193	.000767	.3785	.5273	.004108
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.269 *D*	1.35 *P*	2.218 *D*	12.951 *D*	5.90 *P*	12.533 *D*	7.265 *P*	9.302 *P*	8.424 *P*

Eurodollar Deposits
(London, interbank, bid)
March 25

7-day	14.375
1-month	14.8125
3-month	15.00
6-month	15.0625

International Arbitrage
(3-month, hedged) + in favor of U.S. dollars

U.S.-U.K. Treasury Bills	−1.07
U.S.-Canada Treasury Bills	− .231
U.S.-Canada Finance Co. Paper	− .666
Eurodollars-U.K. Local Auth. Deposits	+ .150

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.125
Over 7 yrs.	15.00
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.625

Gold Price
London afternoon fixing
331.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Saudi Arabia: Projected oil exports needed to meet government's annual financial requirement

(billion dollars, current prices, calendar years)

		1980 (Base)	Third Plan Period 1981	1982	1983	1984	1985	1986
	Total budget outlay	$60.0[1]	70.0	85.0	95.0	100.0	100.0	115.0
Less:	**Non-oil income**	$12.2	17.6	17.2	17.6	18.8	19.6	20.9
	Gas, Petrochemical, and other exports[2]	3.5	4.4	5.0	5.1	6.0	6.5	7.5
	Income from foreign assets[3]	7.5	11.7	10.4	10.4	10.4	10.4	10.4
	Other budget income[4]	1.2	1.5	1.8	2.1	2.4	2.7	3.0
Equals:	**Oil export income requirement**	$47.8	52.4	67.8	77.4	81.2	80.4	94.1
Thus:	**Implied oil export requirement**[5]							
	If net revenue per barrel (yearly average) is:		$31.25	32.30	32.30	32.30	32.30	32.30
	Then, needed export volume is (mbd):		4.6	5.8	6.6	6.9	6.8	8.0

1. Based on *actual* budget outlays in fiscal 1979/80 and 1980/81 of $56.23 billion and $63.66 billion, respectively, representing 89.2% and 80% of budgeted (including supplementary) allocations. 2. Estimates by Chase Energy Economics. 3. Assumes 8% rate of return during 1982-86 on official foreign assets of $130 billion at end-1981 which are not drawn-down. 4. Mainly customs duties and pilgrims' receipts. 5. Assumes marker price holds at its current level of $34 through 1986.

Data: Chase Economics Group estimates

Saudi Arabia: How Much Room to Maneuver?

In a surprising demonstration of unity, members of the Organization of Petroleum Exporting Countries have successfully interjected an element of doubt into expectations that world oil prices would continue to plummet. At their recent meeting in Vienna, OPEC oil ministers agreed to cut production—effectively by some 700,000 barrels per day—in hopes of taking up the current slack in the world oil markets. Saudi Arabia took on the principal burden of the adjustment by deciding to reduce its daily production by 500,000 barrels beginning April 1. This would bring its Aramco output ceiling to 7 million barrels per day (mbd)—well below its "traditional" ceiling of 8.5 mbd and a huge drop from its overall production peak of 10.6 mbd during October of 1980.

Whether this large production cut by the Saudis, combined with output curbs by the other OPEC members, will be sufficient to prop up the cartel's pricing structure remains to be seen. If it is not, further reductions may be required, and Saudi Arabia will undoubtedly play the pivitol role in the OPEC pricing drama once again. Thus, one of the questions most critical to the oil price outlook is: How much further will the Saudis be willing and able to pare back production?

Until recently, Saudi Arabia had been producing petroleum at a rate far above 8.5 mbd and much more than necessary to meet its overall financial requirements. Including its share of yields from the Neutral Zone, Saudi oil output averaged 9.5-10 mbd from the 1978 fourth quarter through 1981. This stepped-up production helped fill the gap in world oil supplies resulting from the 1978-79 Iranian Revolution and the on-going war between Iran and Iraq that began in September 1980. Nevertheless, the yearly average contract price of OPEC oil soared to $34.40 in 1981 from $12.90 in 1978—an increase of 167% in just three years. Without the higher Saudi Arabian production, oil prices undoubtedly would have risen even more rapidly, as stock-building demand for oil during much of this period was exceptionally strong, owing to fears of further supply disruptions. Moreover, this high level of output has been one of the principal causes of the downward pressure on world oil prices that intensified greatly in the early part of this year.

Saudi production policy

Despite the positive price effects for the oil-consuming nations, Saudia Arabia's production policy reflects not altruism, but rather an enlightened self interest that stems from three main concerns. First and foremost, the kingdom has proven oil reserves in excess of 168 billion barrels—25% of the non-communist world total. These have a life expectancy of several decades, and the country will remain heavily dependent on them to finance economic development. Saudi officials are quite clearly concerned that too rapid an increase in the relative price of oil would elicit such marked gains in oil-use efficiency and expanded use of alternative sources of energy that the kingdom's long-term oil market would be endangered. Second, to the extent that overly rapid increases in the price of oil contribute to higher inflation in industrialized nations, the Saudi economy is adversely affected: Import costs increase, giving rise to higher domestic inflation, and the real value of Saudi Arabia's large stock of foreign investments erodes. At the end of the last year, the country's foreign assets totaled an estimated $160 billion, of which about $130 billion were officially held. Third, the Saudis recognize their political as well as economic interdependence with the rest of the world. If too rapid an increase in the relative price of oil contributes to economic dislocation, then adverse political changes in friendly countries could result, and Saudi Arabia's strategic interests would be jeopardized.

How big a cut?

It now appears that Saudi Arabia seriously underestimated the extent to which world demand for OPEC oil would drop this year. Unexpectedly strong conservation in the use of oil, switching to alternative sources of energy, continued expansion of non-OPEC petroleum supplies, and persistent recession in the industrialized nations have severely weakened the demand for OPEC oil. And in the face of unusually high interest rates, consumers have heavily drawn down oil inventories in recent months. Whether OPEC's just agreed upon production cutbacks will be sufficient to absorb the current glut of oil depends on when—and if—demand firms. This may be later in the year, depending on both how much longer the inventory drawdown continues and when the economic recession in the West bottoms out. The OPEC ministers are monitoring trends closely and have indicated their readiness to take further action. Should it become necessary to impose additional output cuts, it is clear that Saudi Arabia would have to bear the brunt of the adjustment, given that production by the other OPEC nations is already extremely constrained.

Hence the critical question that arises is: To what extent could Saudi Arabia cut its oil exports and still meet its financial requirements without incurring budget deficits or reducing the level of its officially held foreign assets? The answer to that question depends

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on several key variables: a) the government's projected spending levels, b) future non-oil income, c) associated gas needs, and quite obviously, d) the price of oil.

Unofficial estimates of future levels of government expenditures have differed widely. Despite shortfalls in the implementation of development projects during Saudi Arabia's second five-year plan period, which covered fiscal years 1975/76-1979/80, state budget civilian *and* military outlays totalled $198 billion in current prices. This equalled 84% of projected spending in inflation-adjusted terms. Under the third development plan (fiscal years 1980/81-1984/85) which is currently being implemented, civilian expenditures alone as originally proposed totalled $234 billion in constant (1979/80) prices. This spending target reportedly has since been raised by 15%. The plan also includes an allowance for inflation of 7% in the case of new projects, although domestic inflation, as measured by the non-oil GDP deflator, is more likely to average around 10% over this five-year period. When outlays on defense and internal security are added, plus internal transfer payments and foreign aid in the form of grants and loans, *overall* spending by the government during 1981-85 will be close to $450 billion in current prices.

The table on page 6 illustrates the annual pattern these expenditures could follow over this five-year period and the concomitant implications for Saudi oil revenue needs. Included in these calculations are: projected state income from the export of natural gas liquids and from petrochemical and other industrial projects currently under construction, estimated returns on foreign assets, and other budget income. It is conservatively assumed that the petrochemical and other industrial projects, due on stream during 1983-85, do not attain full capacity production before 1987. Associated gas needed for fuel and feedstock for Saudi industries and power stations by that date requires crude oil exports of at most 6 mbd, given that a large portion of the gas currently produced is still unutilized, that Saudi fields have high gas-to-oil ratios, and that dual-fuel systems are readily available.

The table on page 6 shows projected requirements for Saudi Arabia's oil export income under these assumptions from 1981 to 1986. In the table below, these are then translated into the associated minimum oil export volumes that would meet these requirements under various oil-price assumptions. If the current benchmark price holds at $34 per barrel thru 1985, the kingdom could cut its exports to an average of 5.8 mbd this year (that is, cut production to 6.3 mbd including oil for domestic use) and export an average of 6.5 mbd during 1982-85. If the marker holds through 1983, then rises 8% in 1984 and 1985, Saudi exports would average 6.2 mbd during this period. But if the marker collapses—for example, falling to $28 by April and to $24 in current dollars by 1985—then, to meet its annual budget requirement, Saudi Arabia would need to sharply and steadily increase oil exports from 6.5 mbd this year to 9.5 mbd by 1985, and possibly to 11 mbd by 1986.

Saudi Arabia's minimum oil export needs
(million barrels/day)

If price of marker crude*:	Oil exports					Annual average
	1982	1983	1984	1985	1986	1982-85
A. Holds steady	5.8	6.6	6.9	6.8	8.0	6.5
B. Rises moderately	5.8	6.6	6.4	5.8	6.2	6.2
C. Collapses	6.5	8.8	9.2	9.5	11.1	8.5

*Refers to current dollar price of Saudi Light oil, now $34 per barrel. In scenario A, marker holds to 1986; in B, it rises 8% in 1984 and 1985, 10% in 1986; and in C, it falls to $28 in April 1982, $25 in 1983 and 1984, and to $24 in 1985 and 1986. Calculations are based on the estimated oil income requirement (see table on page 6) and weighted average net government revenue per barrel. They do not account for output needed to meet domestic oil consumption.

Data: Chase Economics Group estimates

Implications

Several important conclusions can be drawn from this analysis. First, if demand for OPEC oil does *not* decline steadily in the 1980s, Saudi Arabia could contribute significantly to defending the benchmark oil price and still meet its overall budgetary needs by cutting exports to as low as 5.8 mbd this year—that is, about 1 mbd *less* than the level implied by the new Aramco output ceiling for April—and by selling an annual average of no more than 6.2-6.5 mbd thru 1985.

Second, and apart from the pressing needs of other OPEC members, it is in the Saudi's interest to defend the current benchmark price. If they do not, or cannot, and if the OPEC price structure collapses as a result, the Saudis would be faced with two choices: They either would be forced to sharply cut their own spending targets, as even a total drawdown of foreign assets would finance only two years of expenditure at currently projected levels; or they would have to expand future oil exports very sharply. Given the slow growth in world demand currently projected for OPEC oil, this latter alternative would seriously conflict with the oil export requirements of other OPEC members. Thus, continued downward pressure would be exerted on nominal oil prices through at least the mid-1980s. Steadily expanding production could, moreover, heighten the reported conflict within Saudi Arabia between those who have favored and those who have opposed high oil output, whereas lower production would alleviate potential tensions. *Sharif Ghalib*